Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:LN:TL-N-55-99
[redacted]

date: FEB 16 1999

to: Chief, Examination Division, [redacted] District
Attn: [redacted] and [redacted]

from: District Counsel, [redacted] District, [redacted]
[redacted], Assistant District Counsel
[redacted], Attorney

subject: Trade-in or down payment as income to [redacted]

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ISSUES

1. Does the down payment or the value of a trade-in made by a lessee to the dealer at the inception of a lease constitute rental income to [redacted] ("[redacted]") if [redacted] then purchases the vehicle from the dealer?

2. Does the down payment reduce [redacted]'s basis for depreciation in the vehicles?

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CONCLUSIONS

1. [redacted] does not have income as a result of the trade-in or down payment made to a dealer. There has been no realization event.

2. [redacted]'s basis in the vehicles is lower as a result of the fact that [redacted] pays less for the vehicles if the dealer received a trade-in or a down payment. The trade-in or down payment does not, by itself, reduce [redacted]'s basis.

FACTS

[redacted] provides financing for the purchase or lease of new and used vehicles. The dealer treats all transactions, whether a lease or purchase, as a sale of a vehicle.[1] A customer may also trade in a vehicle or pay a down payment. The amount of the allowed trade in or the down payment will reduce the lessee's monthly payment on the lease. In effect, the lessee is making an advance payment on the lease in order to lower the lessee's monthly lease payment. [redacted] pays to the dealer, the "net" amount due on the vehicle and assumes the liability for the vehicle. (The net amount is the negotiated cost of the vehicle less the cash down payment or the trade in allowance on the transaction.) The cash (or vehicle traded in) remains with the dealer. [redacted] reports no income from the down payment or trade-in allowance. The "net capitalized cost" of the vehicle (negotiated cost less down payment or trade in allowance) is used as taxable basis for the vehicle. The method used for tax depreciation is MACRS--5 years using prescribed tables. At the termination of the lease, if the leased vehicle is not purchased at the residual value, [redacted] disposes of the vehicles at auction. [redacted] reports a gain or loss on the disposal of the vehicle.

The Service would like to treat the trade-in or down payment as income to [redacted] in the first month of the lease. The following examples illustrate some of the transactions occurring in a lease. Assume vehicles are identical.

Example 1: No down payment nor trade in allowance.

MSRP or Vehicle Lease Price: $21,400

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[1] We were perplexed by this statement in the fact portion of your memorandum and the later assertion that the finance company, [redacted], took depreciation deductions with regard to the vehicles. These two statements seem to be inconsistent. See Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982). We assume that the dealers treated the transactions as sales in anticipation of the soon to be realized sale of its remaining interest in the vehicles to [redacted].

Less Down payment: -0-
Net due Dealer: $ 21,400

[redacted] pays to the dealer $21,400. [redacted] uses $21,400 as depreciable tax basis. Income is reported monthly, as the lessee makes the monthly payment.

Example 2: Lessee makes a down payment of $4,700

MSRP or Vehicle Lease Price: $21,400
Down Payment: $4,700
Net due Dealer $16,700

In this situation, [redacted] does not report earned income of $4,700 and uses a depreciable basis for tax of $16,700. [redacted] reports income from the monthly payments that the lessee is required to make. The monthly payment will be lower than in example 1, since the lessee has made an advance payment of rent up front.

[redacted] has acquired an asset whose underlying value is $21,400, yet has paid only $16,700 for it. Due to the advance payment, [redacted] is reporting a lower depreciation, and lower income from the monthly payments.

The dollar amount of the adjustments has been agreed to by both the taxpayer and the government. Only the issue of whether the down payments constitute rental income or a reduction of basis is at issue. [redacted] does not keep records of the lessees' down payments. The total amount of the down payments (adjustments) were determined based on a statistical sample of 228 units. ([redacted] could only find 228 of the 300 samples requested.) The average down payment per unit was calculated by taxpayer to be $[redacted] per lease. This figure was extended to the total population as follows:

Year	No. of Leases	Average Down Payment	Total Down Payment
[redacted]	[redacted]	$[redacted]	$[redacted]

LAW AND ANALYSIS

[redacted] does not have gross income because there is no realization event

Section 61 merely defines gross income as income from whatever source derived and then sets forth a nonexclusive list of some commonplace examples of gross income, none of which are applicable here. The Service points to Commissioner v. Glenshaw

Glass Co., 348 U.S. 426 (1955), perhaps the most basic "gross income" definition case to support the proposition that [redacted] has income because there is an economic benefit to it. Glenshaw Glass involved the receipt of punitive damages. The Supreme Court held that receipt of such damages constituted gross income. Glenshaw Glass is generally thought to stand for the proposition that gross income includes all items that are clearly realized accessions to wealth. As stated by the Court:

> Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.

Id. at 431.

Generally, an accession to wealth is clearly realized when it is sufficiently fixed and definite to be treated as gross income. Eisner v. Macomber, 252 U.S. 189, 212 (1920). Realization occurs when the taxpayer takes the last step by which the economic gain comes to fruition. See Helvering v. Horst, 311 U.S. 112, 115 (1940). Thus, there must be a transaction involving the taxpayer for there to be a clearly realized accession to wealth. See, e.g., Baldwin Locomotive Works v. McCoach, 221 Fed. 59, 60 (3d Cir. 1915). Determination of whether gain has been clearly realized must be done on a case by case basis.

There have only been a few situations in which courts found the clearly realized requirement was not met. In Eisner v. Macomber, 252 U.S. 189 (1920), the Supreme Court held that a stock dividend does not constitute gross income because the shareholder, though richer, does not receive any portion of the corporation's assets for her own separate benefit or use; nothing passes from the corporation to the shareholder. In Baldwin Locomotive Works v. McCoach, 221 Fed. 59 (3d Cir. 1915), the Third Circuit held that a taxpayer who owns property that appreciates in value but who does nothing with respect to that property does not clearly realize the accession to wealth that occurs. In Old Colony R.R. Co. v. Commissioner, 18 B.T.A. 267 (1929), rev'd on another issue, 50 F.2d 896 (1st Cir. 1931), rev'd on that other issue, 284 U.S. 552 (1932), the Board of Tax Appeals held that a lessor did not clearly realize the accession to wealth that occurred when the lessee, acting pursuant to the requirements of the lease, replaced portions of the leased property that became unnecessary with property of equivalent value.

In contrast, there are many situations in which the clearly realized requirement is met, and it takes very little activity on the part of the taxpayer for the requirement to be satisfied. For example, the receipt of cash dividends or the sale of appreciated property is a realization of accession to wealth. See section 61(a)(3), (7). The termination of a lease with respect to which the lessee made improvements that revert to the lessor is a case of realization, Helvering v. Bruun, 309 U.S. 461, 468 (1940), but section 109 provides an exclusion from the lessor's income.

As the Supreme Court explained in Eisner v. Macomber, supra:

> After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton's Independence v. Howbert, 231 U.S. 399, 415; Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185). "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case (pp. 183, 185).
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> Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "Derived--from --capital";--"the gain--derived--from--capital," etc. Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;--that is income derived from property. Nothing else answers the description.
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> The same fundamental conception is clearly set forth in the Sixteenth Amendment--"incomes, from whatever source derived"--the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

In short, there can be no income when there has been no realization. Taxing [redacted] as proposed would be similar to taxing a customer who haggled and purchased a car at a price below the sticker price. In fact, taxing such a purchaser might be more logical because he at least has dominion and control over the asset in which the hypothetical gain is reposed. [redacted] does not even have the right to attempt to realize this built-in gain until the end of the lease.

The proposed revenue agent's report makes several arguments for taxation. The first argument was the economic benefit argument mentioned above, which we have addressed. We examine each of the remaining arguments in turn.

The second argument is that the down payment was an advance payment or an advance rental payment. This argument falls short of the mark because the down payment was not a payment at all to [redacted]. The advance payment cases deal with situations where the taxpayer was in actual receipt of income prior to earning it. See, e.g., Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), City Gas Company of Florida, et al. v. Commissioner, 689 F.2d 943 (11th Cir. 1982), rev'g. 74 T.C. 386 (1980); and Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943). In the case of [redacted], there is no actual receipt, much less the "complete dominion" required to treat an advance payment as income. Indianapolis Power & Light, supra.

The third argument is that the down payment is analogous to a payment by a lessee to a third party for the benefit of the lessor. The problem with this theory is that the payment does not benefit [redacted]. [redacted] takes title to the car with a lower basis. This leads to lower depreciation deductions and, when the lease terminates, there should be no difference in residual value between a car for which an advance payment was made and one for which no advance payment was made. At least, there should be no difference as a result of the advance payment.

The fourth argument is that a reduction of basis is not a replacement for recognition of income. As a general statement of the law, this is true. But, unlike the taxpayer in the case cited, Amey v. Commissioner, 22 T.C. 756 (1954), [redacted] did not actually receive the payment. [redacted]'s argument that it received an asset with a reduced basis in these cases is not a separate argument; it is an argument, and a correct one, that [redacted] did not receive any economic benefit from the advance payments.

The fifth argument is that the substance of the transaction should prevail over the form. This is but a variation of the economic benefit theory argument. It, too, is refuted by the fact that [redacted] did not benefit from the advance payments.

The sixth argument is that [redacted] cannot reduce its basis as a purchase price adjustment. This argument is incorrect for the simple reason that [redacted] did, in fact, pay less for the vehicles. It did not adjust the price after the fact.

CONCLUSIONS

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[redacted]
Attorney